No. 13932

In the United States Court of Appeals for the Ninth Circuit

UNITED STATES OF AMERICA,

Appellant,

vs.

EBEN H. CARRUTHERS and NANCY CARRUTHERS,

Appellees.

On Appeal from the United States District Court for the District of Oregon

BRIEF FOR THE APPELLEES

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PRELIMINARY STATEMENT

On May 31, 1950, Eben H. Carruthers granted "an exclusive license to manufacture, use, sell or lease machinery or to practice any method in accordance with or as set forth in" certain "United States and foreign patents and applications for patents, together with the right to sublicense others" to the E. H. Carruthers Company, a corporation, as more fully stated in the agreement (Plaintiffs' Exhibit 5; R. 57-61). The exclusive license was "limited to the tuna canning industry" but extended "to the end of the term of any patent listed or to the end of the term of any patent which may issue upon a patent application listed". (R. 17) During the remaining part of the year 1950 Eben H. Carruthers received the sum of $17,016.75 from the E. H. Carruthers Company for such exclusive license. (R. 18) Appellant now concedes the fact that these patents were capital assets in the hands of appellee Eben H. Carruthers and that they were held by him for more than six months prior to May, 1950, so that the sole question presented to this Court is whether the District Court erred in determining that such amounts constituted proceeds from the sale of a capital asset and, therefore, taxable as long-term capital gains to appellees on their joint income tax return for that year, as provided in Section 117 of the Internal Revenue Code, rather than being taxable to them as ordinary income, under the provisions of Section 22(a) of the Internal Revenue Code, as contended by appellant.

APPELLEES' CONTENTIONS

Appellees contend, and the trial court so found, (R. 19-20) that:

1. The contract of May 27, 1950 (R. 53-57) and the license agreement dated May 31, 1950 (R. 57-61) constituted an absolute assignment and sale of said inventions,

applications for patent and patents, within the meaning of Section 117 of the Internal Revenue Code.

2. The amounts received by appellee Eben H. Carruthers during the year 1950 as "royalties" from E. H. Carruthers Company, an Oregon corporation, by virtue of said agreements, were within the purview of Section 117 of the Internal Revenue Code and were subject to the limitations of Section 117(b) of the Internal Revenue Code.

ARGUMENT

Under the provisions of Title 35, United States Code, Patents, Section 40, a patentee is granted, for the term of seventeen years, "the exclusive right to make, use and vend the invention or discovery . . . throughout the United States and the Territories thereof." Section 47 of the same Title authorizes the assignment of patent rights.

The "license agreement" of May 31, 1950 (Plaintiffs' Exhibit 5; R. 57) granted to the company "an exclusive license to manufacture, use, sell or lease machinery, or to practice any method in accordance with or as set forth in" certain "United States and foreign patents and applications for patents, together with the right to sublicense others", as more fully stated in the agreement. The exclusive license was "limited to the tuna canning industry", but extended "to the end of the term of any patent listed or to the end of the term of any patent which may issue upon a patent application listed". We submit that Mr. Carruthers thereby assigned and sold the entire bundle of rights which he had, except the bare legal title, and that the transaction was not a mere licensing agreement as contended by the Commissioner of Internal Revenue.

One of the earliest discussions of this problem was in the case of *Waterman v. Mackenzie* (1890) 138 U. S. 252. This was a patent infringement suit in which Justice Gray, at Page 256, made the following statement:

> "Whether a transfer of a particular right or interest under a patent is an assignment or a license does not depend upon the name by which it calls itself, but upon the legal effect of its provisions. For instance, a grant of an exclusive right to make, use and vend two patented machines within a certain district, is an assignment, and gives the grantee the right to sue in his own name for an infringement within the district, because the right, although limited to making, using and vending two machines, excludes all other persons, even the patentee, from making, using or vending like machines within the district."

The opinion of the Supreme Court in the *Waterman* case was the basis for the decision of the Tax Court of the United States in the case of *Edward C. Myers v. Commissioner* (1946) 6 T.C. 258. In that case the Tax Court stated the general rule to be that the profit realized upon the grant of an exclusive license to make, use and sell an invention or a patent constituted a capital gain rather than ordinary income.

The *Myers* case was decided in 1946 and has been uniformly followed by the courts and by the Tax Court since that time. *Hofferbert, Collector, v. Briggs* (CCA 4) 178 F. 2d 743; *Allen, Collector v. Werner* (CCA 5) 190 F. 2d 840; *Kronner v. United States* (Ct. Cl.) 110 F. Supp. 730; *Herwig v. United States* (Ct. Cl.) 105 F. Supp. 384; *Pike v. United States* (DC, Conn.) 101 F. Supp. 100; *Thompson v. Johnson, Collector* (DC, N.Y., 1950) 42 American Federal Tax Reports 1284; *Lamar v. Granger* (DC, Pa.) 99 F. Supp. 17; *Dreyman v. Commissioner* 11 T.C. 153; *Taylor v. Commissioner* 16 T.C. 376.

Apparently the appellant seeks to avoid the impact of these decisions by contending that the exclusive license granted here did not constitute a sale, within the meaning of Section 117 of the Internal Revenue Code, because it was limited to the tuna canning industry. We submit, however, that if an item of property is a capital asset then each divisible part of it is likewise a capital asset. If the right conveyed is exclusive as to manufacture, sale and use, then the fact that such rights are retained, as to other parts of the patent, should not have any significance. We believe that this is supported by the following authorities, among others: *Kavanaugh, Collector v. Evans* (CCA 6) 188 F. 2d 234; *Herwig v. United States* (Ct. Cl.) supra; *Lamar v. Granger,* supra, at pages 36-7; *Seattle Brewing & Malting Co. v. Commissioner* 6 T.C. 856; and *Parke, Davis & Company v. Commissioner* 31 B.T.A. 427.

From their inception, the machines in question here were designed solely to pack tuna fish and nothing else. (R. 31-33). Before considering the authorities on this question, we should note the following testimony (R. 33):

> "Q. Mr. Carruthers, do the patents just referred to in this license agreement have any substantial value for any other purpose than the processing of tuna fish?
>
> A. No established value that I know of.
>
> Q. Has any attempt ever been made to use them for any other purpose?
>
> * * * * *
>
> A. No."

In *Kavanaugh v. Evans,* supra, Evans granted an exclusive license to the Kelsey-Hayes Wheel Company on his patent covering a four wheel brake, but reserved to himself the use of the invention in connection with a projected development by him of a short brake pedal, and the right to assign such privilege to one other person. The Circuit Court of Appeals for the Sixth Circuit concurred in the opinion of the District Judge that "the properties sold by the appellee were capital assets and that the profits thereon were taxable as such", and stated:

> "It does not matter that appellee retained the rights set forth in Section 4. It was entirely lawful for him to retain an undivided part or share of his exclusive patent rights. (citing cases)".

In the *Parke, Davis & Company* case, supra, the Tax Court treated the assignment of one-half of the beneficial interest in a patent as a capital transaction.

Two of the above cited cases involved copyrights rather than patents, but we believe that the reasoning therein is applicable to the divisibility of patent rights. The *Herwig* case involved the sale of the movie rights to the book "Forever Amber" to a film producer after the sale of the book rights to a publishing company. The Court of Claims, in rejecting the contention of the Commissioner of Internal Revenue that a copyright is an indivisible asset and that the owner thereof cannot secure capital gains treatment upon the sale of a part thereof, concluded:

> "We believe that it is not only logical but also practical and just to consider the exclusive and perpetual grant of any one of the 'bundle of rights' which go to make up a copyright as a 'sale' of personal property rather than a 'mere license' ".

The Tax Court, in the *Seattle Brewing & Malting Co.* decision, accorded capital gains treatment to the grant of an exclusive right to use the trade name "Rainier" solely within the State of Washington and the Territory of Alaska.

The Commissioner of Internal Revenue, having been defeated in the courts in his attempt to avoid the general rule first announced in the *Myers* case, supra, has sought remedial legislation in the past. During the drafting of the 1950 Revenue Act, the House of Representatives attempted to deny capital gains treatment to the gains from the sale of patents and inventions. The Senate deleted this provision, however, and the House receded on its proposal. The report of the Senate Finance Committee (No. 2375, August 22, 1950) stated that:

> "The desirability of fostering the work of such inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words 'invention', 'patent' and 'design' have been eliminated from this section of the bill".

CASES CITED BY APPELLANT

On pages 8 and 9 of appellant's brief, there are cited a number of cases dealing with the distinction between the assignment of a patent and a bare license thereof. These cases, for the most part, reiterate the general principles enunciated by the Supreme Court in the early case of *Waterman v. Mackenzie,* supra. Some of these cases are patent infringement suits rather than tax cases, and some of the tax cases involved the application of sections of the Internal Revenue Code relating to the taxing of amounts received by non-resident aliens. Many of the cases cited by appellant held that the "license agreement" involved therein constituted an assignment and sale rather than a bare license, and we believe that several of these cited cases directly support appellees' position.

Other than *Waterman v. Mackenzie,* supra, which is the leading case on this general subject and which we have heretofore cited and discussed, the appellant first cites the case of *United States v. General Electric Co.,* 272 U. S. 476. That decision was rendered in an anti-trust suit brought by the government and merely restates the general rule of the *Waterman* case, with which we have no quarrel.

Six Wheel Corporation v. Sterling Motor Truck Co., 50 F. 2d 568, a 1931 decision of this Court, was a patent infringement suit in which the question was whether or not the plaintiff assignee had the right to sue. This Court held that the purported assignment, which was hedged with numerous conditions and did not give the purported assignee the right to make, use and sell, did not give the plaintiff therein the right to prosecute the infringement suit. This Court discussed, in general terms, the rights which an inventor has under the patent laws and followed the general principles of the *Waterman* case.

Gregg v. Commissioner, 18 T. C. 291, which was affirmed per curiam by the Circuit Court of Appeals for the Third Circuit, 203 F. 2d 954, involved a license to manufacture and sell rope sole shoes in the United States for a term of one year, with automatic yearly renewals subject to cancellation by either party. If the licensee could not meet the demand for the product, then the taxpayer could exercise his reserved right to license others. The agreement in question there also provided that a suit for infringement could be brought by either party. The Tax Court properly held that this was not equivalent to a sale of the patent.

Broderick, Collector v. Neale (CCA 10) 201 F. 2d 621, involved two license agreements. The first agreement was for one year, only, and did not include the right of the licensee to use the patent. This short term license was held not to be an assignment, but it is interesting to note that the government did not appeal the decision of the District Court that an effective assignment was made by the second agreement, which was for the life of the patents.

Bloch v. United States (CCA 2 1952) 200 F. 2d 63, was carefully distinguished by the Court of Claims in its decision in *Kronner v. United States,* 110 F. Supp. 730, which was also cited by appellant. The Court of Claims pointed out the fact that in the Bloch case the question involved was whether royalty payments received by a non-resident alien represented taxable income to him under Section 211(a) of the Internal Revenue Code, and stated that it "must be distinguished from our case wherein a resident citizen and Section 117 are involved".

Just why appellant cites *Allen v. Werner* and *Kavanaugh v. Evans* in support of its position is not clear, inasmuch as these are two of the strongest cases supporting the position of the appellees. We have previously cited and discussed these cases.

Hook v. Hook & Ackerman (CCA 3 1951) 187 F. 2d 52, was a declaratory judgment suit involving a claimed infringement of a patent. The agreement in question there was held to be an assignment rather than a license, under the general rule announced in the *Waterman* case.

The next two cases cited by appellant, like *Bloch v. United States,* supra, involved the taxing of non-resident aliens. *Commissioner v. Celanese Corporation* (CCA DC 1944) 140 F. 2d 339; and *General Aniline & Film Corporation* (CCA 2 1944) 139 F. 2d 759. Sections 143 and 211(a) of the Internal Revenue Code require that any "fixed or determinable" income paid to non-resident aliens from within the United States be withheld at the source. The regulations of the Commissioner of Internal Revenue describe royalties as such income, but exclude the gain from the sale of property by non-resident aliens where the sale is made outside the United States. *Regulations 111, Sections 29.143-2 and 29.211-7.* For these reasons it becomes important for the Commissioner in those cases to establish the fact that a license was granted, rather than a sale made, by the non-resident alien patent owner if a tax is to be imposed.

At least a gain on a sale of a patent right by a citizen will be taxed at capital gains rates. A sale by a non-resident alien, however, is entirely exempt from taxation if the transaction is consummated in a foreign country.

Under the facts in the *Celanese Corporation* case, the agreement was held to be a sale, not a license, and the taxpayer's position was upheld. The decision of the Tax Court in favor of the government in the *General Aniline & Film Corporation* case was reversed by the Court of Appeals for the Second Circuit. Here, again, the citation of this case by the government, in support of its position, is a source of wonder, particularly in view of the fact that the Court of Appeals, in finding an assignment and holding in favor of the taxpayer, said that it was unimportant "that the assignor, before making the assignment, had granted to others some rights under the patent". Even though these cases involved Section 117 of the Internal Revenue Code, they would not be helpful to appellant here.

The last case cited by appellant is *Kenyon v. Automatic Instrument Co.* (CCA 6, 1947) 160 F. 2d 878. This was not a tax case, but was a suit to recover damages for breach of an agreement to pay royalties. Appellees believe that this case has no application to the instant case, even though the agreement in that case was held to be an assignment rather than a license.

On pages 9 and 10 of appellant's brief the statement is made that the taxpayer first assigned some of the patents involved to the company and, thereafter, at a special meeting of the stockholders, it was decided to reassign the patents to the taxpayer. In emphasizing this transaction, the appellant is endeavoring to piecemeal and segregate a small part of the entire record. Consideration of the minutes of the stockholders' meeting on April 1, 1950 (Plaintiffs' Exhibit 2; R. 42-43) will disclose the fact that such assignments were made by inadvertence and, had they been otherwise, all of the patents and applications involved would have been assigned and not just the few that were. There was never any consideration paid to Mr. Carruthers for either the agreement of 1947 (Plaintiffs' Exhibit 1; R. 35) and certainly not for the assignments which were inadvertently made and subsequently reassigned, nor does the record support in any way the suggestion by appellant that there was any consideration for the reassignment by the company to Mr. Carruthers. A partial explanation of the transaction is found on pages 42 and 43 of the record, and a more complete explanation is found on pages 37 and 38 of the transcript of proceedings in the District Court, which the appellant did not see fit to include in its designation of the record on appeal even though it must have then intended to raise this point for the first time.

The agreements or assignments which may have been made prior to the execution of Plaintiffs' Exhibits 4 and 5 in May, 1950, are wholly immaterial. The full record discloses that until that date there had never been any complete understanding between appellee and the E. H. Carruthers Company. No consideration had ever been paid or determined for the rights to the use of the patents involved, and the sole and primary purpose of the meeting of the stockholders (Plaintiffs' Exhibit 2; R. 41) and of the agreement of May 27, 1950 (Plaintiffs' Exhibit 4; R. 53) was to definitely settle and determine the rights of these parties to the property involved. This is the one and only transaction between these parties in which present and future rights were transferred and for which consideration was paid and received, and is the only transaction before this Court.

The reason for the transfer of patent rights by license rather than by outright assignment is clear. The Court will observe that in substantially all of the cases cited and involving similar questions the transfer is in the form of a license rather than an outright assignment. Inventors grant such an exclusive license and retain the bare legal title in order to have the right to cancel the license agreement upon non-performance or upon the failure by the exclusive license holder to fully exploit the invention. This is the best security that the patent holder has. If he has assigned the full legal and equitable title to the processing or manufacturing company and such company fails to exploit the patent or to otherwise perform the agreement, the patent holder is then left to a suit for damages which would be an unsatisfactory and unworkable remedy. His right to cancel such an exclusive license agreement for non-performance, however, is a simple and readily available remedy and permits him to make sure that his patent is fully exploited without requiring the long delay that litigation might entail.

Appellant says, on page 11 of its brief, that "The taxpayer, himself, testified before the lower court that he thought his patents could be applied to another industry". To the contrary, the testimony (R. 31-35) and the patent applications (R. 65-80) show that, while there was a remote possibility that the inventions might have been used other than for the packing of tuna, that possibility had no substantial value. No attempt has ever been made to use them for any other purpose (R. 33). The fact that the claims in the patent applications went beyond the tuna canning industry is unimportant. It is the commonly accepted and recommended practice to make such claims as broad as possible. (R. 34) *Walker on Patents, Deller's Edition, Vol. II, pages 770-771.*

The final argument of appellant, which appears on page 11 of its brief, is that any assignment of a patent for a consideration which is measured by the profits which the assignee receives from it is a mere license. The Supreme Court answered this argument as early as the year 1888, in the case of *Rude v. Westcott,* 130 U. S. 152, at 162-3, when it said:

"The concluding provision, that the net profits arising from sales, royalties, or settlements, or other source, are to be divided between the parties to the assignment so as to give the patentee one fourth thereof, does not, in any respect, modify or limit the absolute transfer of title. It is a provision by which the consideration for the transfer is to be paid to the grantor out of the net profits made; it reserves to him no control over the patents or their use or disposal, or any power to interfere with the management of the business growing out of their ownership."

The Commissioner of Internal Revenue advanced this same argument for many years until the 1946 decision of the Tax Court in *Edward C. Myers v. Commissioner,* supra, which held that profit, no matter how determined, realized upon the grant of an exclusive license to make, use and sell an invention or a patent, constituted a capital gain rather than ordinary income. The Commissioner acquiesced in that decision (*Cumulative Bulletin 1946–1, 3*), but about four years later, and on March 20, 1950 (about the time Congress was rejecting his application for a change in the law), the Commissioner reversed himself again and withdrew his acquiesence in the *Myers* decision. He then took the position that royalties received during taxable years beginning after June 1, 1950 from exclusive license agreements, constituted ordinary income (*Mimeograph 6490; Cumulative Bulletin 1950–1, 9*). Of course, we have involved here a taxable year beginning prior to June 1, 1950, but appellees do not rely upon this fact. Appellees believe that the Commissioner was right in his initial acceptance of the *Myers* case and was wrong when he changed his mind. The Courts of Appeal and the Tax Court have consistently agreed with the appellees' position and disagreed with the Commissioner. His stubborn refusal to follow the courts on this question accounts for much of the litigation in this field.

CONCLUSION

The trial court, in its findings of fact, (R. 19) found that the license agreement constituted an absolute assignment and sale of all of the inventions, applications for patent and patents described therein, and that the amount of $17,016.75 received by Eben H. Carruthers in the year 1950 as "royalties" was in consideration for such assignment and sale. In view of the foregoing, we submit that these findings of fact by the trial court were not "clearly erroneous", within the purview of *Rule 52(a) of the Federal Rules of Civil Procedure,* and that the judgment of the trial court is correct and should be affirmed.

Respectfully submitted,

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